

Minnesota

Department of Finance

October 2002

State Revenues on Forecast for First Quarter of FY 2003

Net general fund revenues totaled \$2.863 billion in the first quarter of fiscal 2003, \$43 million (1.5 percent) more than end of session estimates. The entire positive variance is attributable to one extremely large estate tax payment. Without that payment, state revenues would have been below forecast for the quarter. Receipts from the individual income tax, the sales tax, and the corporate income tax all were less than forecast. Only the general fund portion of the motor vehicle excise tax and "other" taxes exceeded forecast.

Summary of Tax Receipts: (July – September, 2002)

	<u>Estimate</u>	<u>Actual</u>	<u>Variance</u>	<u>Percent</u>
	----- (\$ in millions) -----			
Income	1,403	1,370	(33)	(2.4)
Sales	873	867	(6)	(0.7)
Corporate	180	169	(11)	(6.1)
Motor Vehicles	66	83	17	25.7
Other	<u>298</u>	<u>374</u>	<u>76</u>	<u>25.5</u>
Total	2,820	2,863	43	1.5

Estate tax collections were \$56 million more than forecast. This quarter's receipts exceed the total amount received during all of fiscal 2002. Mortgage and deed tax payments were \$17 million more than forecast due to a surge in mortgage refinancing stimulated by historically low mortgage rates. Motor vehicle excise tax receipts also were \$17 million above forecast reflecting recent special incentives offered to promote auto sales.

Receipts from the individual income tax, the sales tax, and the corporate income tax were less than projected. Individual withholding tax receipts, the single largest source of state revenues, closed the quarter \$16 million (1.5 percent) below forecast. Third quarter individual and corporate estimated tax payments were down \$19 million and \$23 million respectively. (See page 6)

Following year-end closing the revenue shortfall for fiscal 2002 was reduced to \$202 million, \$10 million less than reported in *July's Update*. After adding the \$43 million positive variance from the first quarter of FY 2003, biennial revenues are currently \$159 million below forecast.

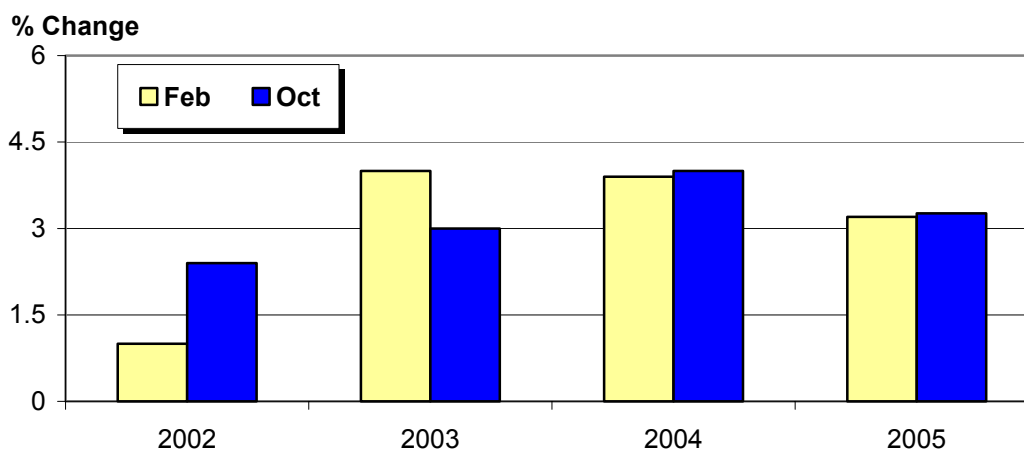
A Tepid U.S. Economy Waits For Business Spending To Resume

The recession is over and the U.S. economy is recovering, even though the stock market averages have yet to notice. Real growth rates will not match those of the supercharged years of the late 1990's, but even during those heady times forecasters were saying those growth rates were not sustainable. Now, following the recession we are proceeding slowly toward re-establishing a foundation for a period of sustained economic growth.

Typically recessions are followed by several quarters of extremely strong growth as inventories are rebuilt and production is ramped up to satisfy pent-up demand. This time though, growth rates have not accelerated, and as during the 1990-91 recession, the economy has had trouble getting up to speed and adding jobs. The inventory recovery went as anticipated, producing strong growth during the first quarter of this year, but thus far there has been no follow through. Spending for business plant and equipment has yet to recover, and capacity utilization rates remain well below levels requiring further investment. Economists all have the same question, when will business investment begin growing again?

Like virtually every other forecaster DRI-WEFA, Minnesota's national economic consultant, expects the recovery to continue, but at a subdued pace through mid 2003. Business investment then is assumed to accelerate during the latter half of 2003 and early in 2004. The DRI forecast of 2.4 percent growth for calendar 2002 and 3.0 percent growth in calendar 2003 is identical to October's Blue Chip Consensus projection.

DRI Cuts Outlook for Real GDP Growth in 2003



But, while there is a strong consensus about the likely path of the economy over the next 18 months, forecasters also note that significant risks remain. The U.S. economy has endured a number of shocks during the past year, and it is still in a weakened state. There is no guarantee that business investment will pick up by mid 2003. And, the potential war with Iraq is a major concern. Such a war's impact on the U.S. economy would

depend on many factors, but most believe that while actual military action would delay the return to strong, sustainable growth by an additional three to six months it would not produce a recession. DRI assigns a probability of 55 percent to their control scenario, and a probability of 35 percent to a scenario containing a slower recovery.

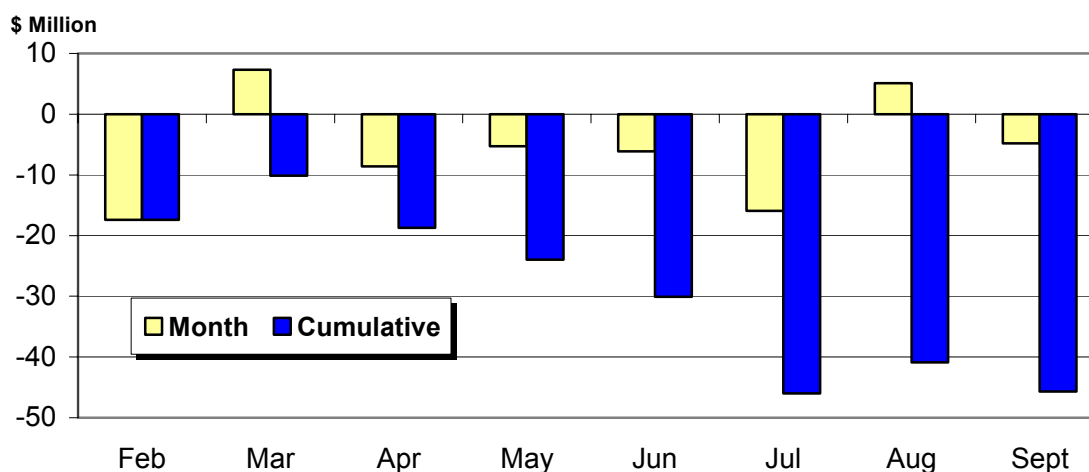
Looking Further Into The Future

DRI's October control projects real GDP growth of 4.0 percent in 2004 and 3.3 percent in 2005. The revenue planning estimates prepared in February were based on real growth rates of 3.9 percent and 3.2 percent. Inflation is expected to remain under control with the CPI projected to grow by 2.9 percent in both 2004 and 2005.

Weaker Revenue Outlook Extends Through 2004-05 Biennium

February's revenue forecast now appears to have been too optimistic. That forecast will not be officially updated until early December, but a further reduction in projected revenues for both the current biennium and the 2004-05 biennium appears likely, since collections have fallen short of forecast. Receipts from revenue sources that reflect current economic activity, such as withholding tax payments and sales tax collections, have been only slightly below forecast but the cumulative impact of those monthly shortfalls is becoming significant. In addition, last spring's final payments and refunds for the individual income tax suggest that individual income tax liability in tax year 2001 was about \$275 million less than anticipated. Unfortunately, the impact of a reduction in income tax liability is not limited to that year alone; projected income tax collections in all subsequent years are also reduced by a similar amount.

Withholding Receipts Continue Slightly Below Forecast

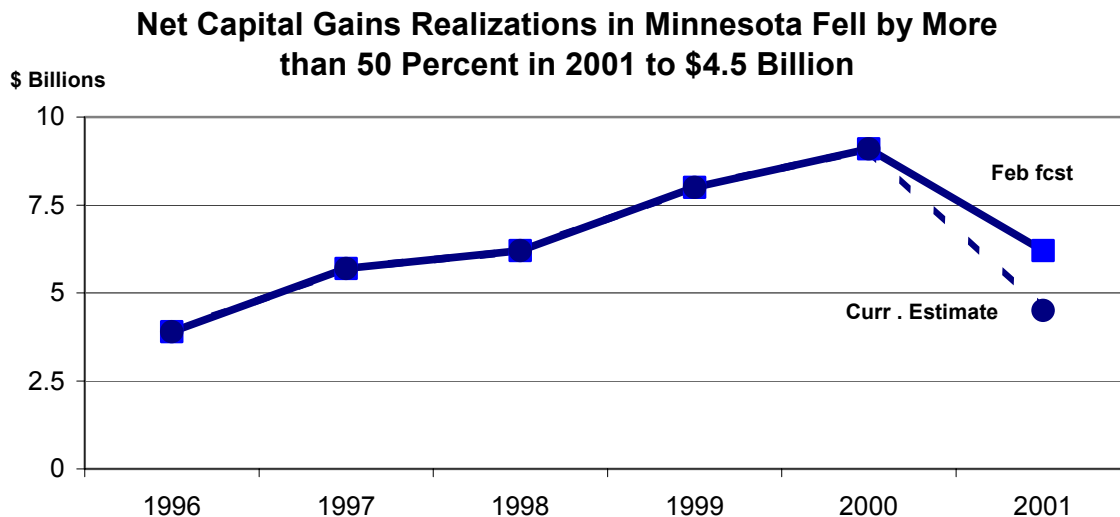


FY 2002 Revenues Were \$202 Million Below Forecast

Net general fund revenues for FY 2002 totaled \$12.185 billion, \$202 million (1.6 percent) less than forecast, but \$10 million more than previously reported. The amount of individual income tax refunds remaining to be processed after the close of the fiscal year were less than anticipated.

The entire \$202 million FY 2002 shortfall is attributable to lower than anticipated settle-up payments and higher than expected refunds for tax year 2001 individual income tax liability. (see page 6) Finance Department economists currently estimate that final individual income tax liability for tax year 2001 will be \$275 million less than forecast in February.

A full explanation of the reasons why tax year 2001 income tax liability fell below projections will not be possible until late in 2003 when breakdowns of income by type of income are available from the IRS. Preliminary analysis, however, indicates that capital gains income must have fallen by an even larger percentage than was assumed in February's forecast. At that time Minnesota capital gains realizations were assumed to fall by roughly one-third, from \$9 billion in tax year 2000 to only \$6 billion in tax year 2001. Now, it appears that capital gains realizations fell by at least 50 percent, and reached no more than \$4.5 billion in tax year 2001.



Fiscal 2003 Revenues Continue On Track, But Deficit Likely For Current Biennium

Minnesota's 2002 Legislative Session adopted a budget leaving for a \$319 million ending balance for the current biennium. Actions taken in the special legislative session reduced the expected balance to \$318 million. Factoring in the \$202 million shortfall in FY2002 receipts as well as the \$43 million positive variance in revenue collections for the first quarter would leave an expected ending balance for the end of the biennium of \$159 million in the absence of any other changes. Until a new forecast is issued, however, the official projected ending balance remains at \$318 million.

Looking forward, the lower observed tax year 2001 individual income tax liability will reduce the base for the tax year 2002 forecast by \$275 million from February's estimate. In the absence of any other changes, that reduces the forecast for individual income tax receipts by \$275 million, leaving a shortfall of \$116 million for the current biennium. If, as now appears to be the case, the economic outlook is weaker than that used in preparing February's revenue forecast, expected revenues would be even lower, and the projected deficit larger.

Official Planning Estimate For FY 04-05 Budget Shortfall Remains At \$1.6 Billion, But Current Receipts Indicate A Larger Deficit Is Likely

The official estimate of the projected budget shortfall for the 2004-05 biennium is based on current law and will not change until the Finance Department issues a new forecast in early December. That forecast will combine data on current receipts and expenditure changes with new economic forecasts for the U.S. and Minnesota to produce a comprehensive estimate of current law expenditures and revenues for the next biennium. Those estimates will be the basis for the budget the next governor submits to the Legislature in February, 2003.

But, while the official estimate of the FY 2004-05 shortfall remains unchanged, the reduction in tax year 2001 liability will continue to carry forward, reducing expected receipts in both fiscal 2004 and fiscal 2005. That change by itself, if not offset by an improved outlook for the economy, will raise the projected budget shortfall for the next biennium to \$2.1 billion. Collection experience since the end of session provides no indication of an improvement in the outlook, nor does a comparison of the October, 2002 DRI Control forecast to the economic projections which served as the basis for February's 2004-05 revenue planning estimates.

Comparison of Actual and Estimated Non-Restricted Revenues

(\$ in thousands)

	2002 Fiscal Year			July - September 2002		
	Forecast Revenues	Actual Revenues	Variance Act-Fcst	Forecast Revenues	Actual Revenues	Variance Act-Fcst
Four Major Revenues:						
Individual Income Tax						
Withholding	4,782,499	4,762,521	-19,978	1,172,175	1,156,554	-15,620
Declarations	1,065,000	999,950	-65,051	220,316	201,646	-18,669
Miscellaneous	727,000	587,031	-139,969	40,846	43,407	2,561
Gross	6,574,500	6,349,501	-224,998	1,433,336	1,401,607	-31,729
Refund	841,300	906,159	64,859	30,065	31,395	1,330
Net	5,733,200	5,443,342	-289,857	1,403,271	1,370,212	-33,059
Corporate & Bank Excise						
Declarations	619,247	595,898	-23,349	167,538	144,722	-22,816
Miscellaneous	93,893	116,906	23,013	24,136	37,636	13,500
Gross	713,140	712,804	-337	191,674	182,359	-9,315
Refund	183,600	183,346	-254	11,800	13,759	1,959
Net	529,540	529,457	-83	179,874	168,599	-11,274
Sales Tax						
Gross	3,995,661	4,006,006	10,345	928,512	913,349	-15,163
Refunds	258,159	232,532	-25,627	55,000	45,701	-9,299
Net	3,737,502	3,773,474	35,972	873,512	867,647	-5,865
Motor Vehicle Sales	418,228	424,711	6,483	65,999	82,916	16,917
Other Revenues:						
Inherit/Gift/Estate	65,000	68,174	3,174	13,000	69,255	56,255
Liquor/Wine/Beer	59,000	58,067	-933	14,779	16,051	1,272
Cigarette & Tobacco/Cont Sub	161,076	168,237	7,162	43,310	49,382	6,072
Deed and Mortgage	200,100	229,260	29,160	46,559	63,250	16,691
Insurance Gross Earnings	205,700	176,661	-29,039	52,775	46,863	-5,912
Lawful Gambling	58,377	59,314	937	12,568	12,281	-287
Health Care Surcharge	151,537	152,521	984	34,283	34,383	100
Other Taxes	3,054	1,333	-1,721	503	836	333
Statewide Property Tax	296,000	305,573	9,573	0	182	182
DHS RTC Collections	68,153	75,368	7,215	12,435	14,709	2,274
Income Tax Reciprocity	47,899	47,899	0	0	0	0
Investment Income	75,000	82,808	7,808	6,667	7,012	345
Tobacco Settlement	149,614	154,767	5,153	0	0	0
Departmental Earnings	187,159	188,090	931	45,683	43,939	-1,744
Lottery Revenues	28,887	31,057	2,171	7,221	4,386	-2,835
2000 Sales Tax Rebates	-32	-32	0	0	0	0
2001 Sales Tax Rebates	7,000	11,081	4,081	0	-87	-87
Revenues yet to be Allocated	0	-144	-145	0	660	660
Residual Revenues Less Refunds	238,339	234,594	-3,745	10,069	15,846	5,777
Other Subtotal	2,001,863	2,044,627	42,764	299,582	378,947	79,096
Other Refunds	33,694	31,044	2,650	2,469	5,744	3,275
Other Net	1,968,169	2,013,583	45,415	297,383	373,203	75,821
Total Gross	13,703,392	13,537,649	-165,743	2,919,372	2,959,178	39,805
Total Refunds	1,316,753	1,353,081	36,329	99,334	96,599	-2,735
Total Net	12,386,639	12,184,568	-202,071	2,820,038	2,862,579	42,540